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Eliminate or Reduce the Business Personal Property (BPP) Tax

Explain proposal:
Business personal property (BPP) taxes are imposed on the full cash value of property (equipment) used for commercial, industrial, utility, mining or agricultural purposes. The business owner is required to file an annual Business Property Statement by April 1. The business owner reports the cost and type of personal property by year of acquisition for each business location. The County Assessor determines the depreciated or full cash value of locally assessed property (commercial, industrial & agriculture) based on the type of equipment, percent good tables prepared by the Arizona Department of Revenue (ADOR), and other statutory requirements. ADOR administers the BPP tax on centrally assessed properties (ex. utilities and mines). All BPP is normally subject to property tax, except for inventory held for resale and certain animals.

Under the Arizona Constitution and A.R.S. § 42-11127, the 2003 property tax exemption for locally assessed commercial and agricultural BPP is $55,465. This constitutional exemption was approved to reduce the property tax costs on small business and reduce administrative compliance costs.

Most states impose a BPP tax, but at the same time provide for property tax abatements and incentives for targeted industries (ex. Manufacturers) and/or targeted areas (ex. Enterprise Zones).

The following states have no BPP tax:

DE	Industrial machinery only
IA	
IL	
MA	Manufacturers only
MN	
NH	Machinery & equipment only
NJ	
NY	
PA	
SD	

The Legislature has the authority to enact laws to modify the existing property tax system, including creating new property tax classes, changing class assessment ratios, and adjusting taxable values for specific types of property. Legislative changes must be uniform and nondiscriminatory within each class of property. The Legislature doesn't have the authority to create a BPP tax exemption. Such a property tax exemption requires an amendment to the Constitution.

Per ADOR analysis of the 2002 property tax roll, BPP (both centrally and locally assessed) tax of $667M was collected in 2002. BPP tax represents $15.4% of total property tax revenue collected in 2002.

Category	2002 Full Cash Value-Taxable	2002 Net Assessed Value	2002 Est Tax $ (before Homeowners rebate and 1% limitation)	% of total
Residential (Owner Occupied & Rental)	182,682,398,620	18,268,239,862	$2,246,741,666	51.1%
Business Real	38,903,069,456	7,780,613,892	$1,146,861,833	26.1%
Business Personal	21,702,985,188	5,425,746,297	$ 677,381,871	15.4%
Other – diff			$ 329,014,630	7.5%
Total 2002 Property Tax Roll			$4,400,000,000	100.0%

Under the theory that state and local government will need to collect the same amount of property tax revenue, an elimination or reduction in the BPP tax shifts the tax burden to the remaining property taxpayers (primarily homeowners and commercial real property owners). Unless combined with other property tax reforms, existing tax rates would have to increase by 15% or more to maintain existing property tax revenue of $4.4 billion. A 15%-plus increase in the primary tax rate, unless accompanied by a 15% increase in full cash value, will also cause more homeowners to exceed the 1% cap, necessitating higher costs to the state for the homeowners primary tax amounts that exceed the 1% cap. In addition, if school primary rates are adjusted upward to make up for the lost revenue their will also increased costs to the state general fund for the homeowner rebate (currently 35% of class 3 primary school taxes).

While the proposal before the CFRC is the elimination of the BPP, it is worth noting that previous proposals to eliminate the BPP were focused on only the elimination of locally assessed BPP. The impact of eliminating the locally assessed BPP is dramatically less, as centrally assessed BPP makes up 66% of the total BPP net assessed value.

Assuming an only an exemption on locally assessed BPP, the decrease in net assessed value is estimated at $1,814,351,752. This reduction in value, using the state average tax rate, results in $226 million loss in revenue.

Other BPP Reduction Possibilities:

The proposal before the commission is the elimination or reduction in the business personal property tax. This change could occur under numerous scenarios, and in combination with other property tax reform proposals before the commission. This discussion is limited to 3 alternatives, with static impact based on 2002 property tax roll data from ADOR:

A. Reduce the BPP tax by gradually lowering the assessment ratio

B. Reduce BPP taxable values for targeted industries (ex Manufacturers) through further changes in depreciation schedules

C. Income tax credit for 100% of BPP tax paid

Please see Appendix A for ADOR preliminary analysis of an equalized assessment ratio of 11.6% between business personal and residential property.

Alternative A - Reduce the BPP tax by gradually lowering the assessment ratio:

Under the Constitution, the Legislature has the power to enact laws, but it doesn't have the authority to create a property tax exemption. A BPP exemption would require a constitutional amendment.

The Legislature has the authority to create and change assessment classifications and ratios. To gradually phase out of the BPP tax, the Legislature could use a number of different approaches, including lowering assessment ratios on BPP in specific industries and/or changing scheduled depreciation adjustments. However, targeting the relief to specific industries would likely require the creation of separate class of property for the targeted industries.

Further, a gradual phase out would minimize the impact on remaining taxpayers.

BPP tax (both local and centrally assessed) collected in 2002 was $677M. A phase out at 20% per year, applied to all BPP taxpayers, would approximate:

Year	Phase out %	Estimated property tax $ shift to remaining taxpayers
1	20%	$133M
2	40%	$267M
3	60%	$406M
4	80%	$542M
5	99%	$670M

A phase out of just the locally assessed BPP ($226 million) would be considerably less.

Year	Phase out %	Estimated property tax $ shift to remaining taxpayers
1	20%	$45M
2	40%	$90M
3	60%	$136M
4	80%	$181M
5	99%	$224M

Too long of a phase out period may delay BPP investments until reductions take full effect.

Because this approach does not grant an outright exemption, the Legislature has the authority to enact this type of change. Prior to the constitutional amendment that granted an exemption for the first $50,000 in locally assessed personal property, the Legislature had dropped the assessment ratio on that property to 1%. The courts later confirmed the Legislature's authority to set an assessment ratio at 1%.

Alternative B – Reduce BPP taxable values for targeted industries (ex. Manufacturers) through further changes in depreciation schedules:

Under A.R.S. § 42-13352, the Assessor determines the taxable value of BPP for manufacturers, assemblers or fabricators by the appropriate depreciation prescribed by ADOR, and then adjusts the taxable value by the following percentages:

Depreciation Schedule Adjustments on BPP:	ARS 42-13352
1st yr of assessment	35% of depreciated value
2nd yr of assessment	51% of depreciated value
3rd yr of assessment	67% of depreciated value
4th yr of assessment	83% of depreciated value
5th & subsequent yrs of assessment	Use scheduled depreciated value

The Legislature has the authority to make further changes in the BPP depreciation schedules. For example, a 50% reduction in the above table results in the following proposed percentages:

Depreciation Schedule Adjustments on BPP:	Proposed 50% reduction
1st yr of assessment	17.5% of depreciated value
2nd yr of assessment	25.5% of depreciated value
3rd yr of assessment	33.5% of depreciated value
4th yr of assessment	41.5% of depreciated value
5th & subsequent yrs of assessment	Use scheduled depreciated value

This alternative would reduce the BPP taxable value for the targeted industries only, and minimize the impact on existing tax rates and the increased costs to the state for homeowner rebate and homeowner primary taxes exceeding the 1% limitation.

Alternative C – Income tax credit for 100% of BPP tax

The creation of an income tax credit would not simplify the property tax system, but would help preserve existing property tax values that impact various tax rates, levy limits, debt limits, etc. An income tax credit further limits the benefit to those businesses with an Arizona income tax liability. Depending on the carry forward provisions for unused credits, an unprofitable business, or a business with minimal Arizona income tax liability, may never realize the full benefit from an income tax credit for BPP tax.

Under Alternative C, the costs of the incentive would be borne exclusively by the State as opposed to all of the taxing jurisdictions that rely on property tax revenues. City and Towns do share in 15% of the state income tax and therefore would also be impacted to a small degree as a result of decreased collections.

Prior efforts to pass in the Legislature to pass a BPP income tax credit have been unsuccessful. In addition to the costs to the state general fund and cities, there was also concern about the state accepting the liability for tax increases at the local level that the State exercises no control over.

How to administer this tax reform:

Systems and personnel are already in place at the County and State to administer and collect the BPP tax. The County Assessor determines BPP tax values based on returns filed by business owners. The County Treasurer prepares and collects BPP tax bills. ADOR determines business personal property tax values for centrally assessed properties (ex. utilities and mines) and prepares and collects BPP tax on centrally assessed taxpayers.

Impact of this tax reform on Existing Revenue Systems:
The BPP tax is primarily administered at the County & State level. Any changes should require minimal administrative cost. Again, to the extent state and local government will still collect the same amount of property tax revenue, a reduction in the BPP tax will result in a tax shift to other property taxpayers.

For some special taxing jurisdictions that have maximum rate caps (fire districts, flood districts, fire district assistance tax etc.) the decrease in value from the loss of BPP could potentially be a direct loss in revenue if the jurisdiction is at the rate cap. However, the Legislature could make adjustments to those maximum rate caps.

While difficult to quantify, the elimination or reduction in the BPP tax would have a positive economic impact, resulting in an increase in other types of tax revenues. The elimination of the BPP would make Arizona more attractive to capital intensive manufactures with significant levels of BPP.

Cost to Administer proposal:

Because systems and personnel are already in place at the County and State to administer and collect the BPP tax, the cost to administer a change in the BPP tax should be minimal. Existing BPP systems can be adjusted for changes in assessment ratios or depreciation schedules. An elimination of the BPP tax reduces compliance costs for both the government and BPP taxpayers.

If the BPP tax is reduced, the impact on compliance costs for business owners is minimal, because businesses are already filing property tax returns. If the BPP tax is eliminated, compliance costs are reduced.

Policy Considerations:

<u>Equity</u>
Arizona's current property tax system the applies varying assessment ratios to nine classifications of property in order to shift the distribution of the tax burden from one class to another fails most equity tests. As has been repeatedly documented, the system results in large inequities in taxes between residential and business property. Arizona's commercial and industrial property taxes have been documented to be some of the highest in the country.
A reduction or elimination of the BPP would improve equity between some business property taxpayers and residential taxpayers. However, because of the tax shift, those business property taxpayers with small amounts of BPP may actually see increases in their effective tax rates.

<u>Economic Vitality</u>

As already discussed, a lower BPP tax should help promote economic development by encouraging investments and business expansion, thereby creating an increase in other types of tax revenue.

<u>Volatility</u>

The amount of BPP tax raised each year is moderately volatile. BPP tax depends upon the amount of capital investment. While the elimination of the BPP would initially reduce the property tax base, the property base would become more stabile in the future because there is less fluctuation in real property values.

<u>Simplicity</u>
An elimination of the BPP tax would simplify the system and reduce administrative costs for both government and business owners. A reduction in the BPP tax wouldn't simplify the system or reduce compliance costs.

Economic Impact:
A reduction in the BPP tax results in a property tax increase on the remaining property taxpayers. However, a lower BPP tax should help promote economic development by encouraging investments and business expansion, thereby creating an increase in other types of tax revenue.

Appendix A – AZ DOR preliminary analysis of proposal to equalize the property tax assessment ratios between business personal and residential property.

This proposal brings up many additional questions.

Should they be equalized for Primary, Secondary or both for taxation purposes? Would it be equalized only for all voter-approved Secondary bonds from this point forward?

In general, changes to assessment ratios have no impact on the revenues raised by local jurisdictions. As property valuations change, local tax rates adjust in order to raise the same amount. The most accurate way to evaluate such proposals is at the parcel-by-parcel level. The Department of Revenue does not have a tool to do this. The proposals can be reviewed at the state and county level. With more time, the proposals could be evaluated at some of the larger sub-county jurisdiction levels.

Regardless of how we measure this, there are many questions that we cannot answer that would affect the impact.

There are some rates that stay constant, regardless of the taxable value they would be applied against. Our methodology assumes that all rates will shift in order to raise the same amount of money.

What will school district tax rates do? School district primary tax rates are governed by a Qualifying Tax Rate and a Truth in Taxation requirement. Once they reach a certain level, they will not increase any more, and the school receives funds through the school funding formula. Will they adjust with a change in taxable property value? We assume that they do.

We know that any change in valuation or tax rates charged on owner-occupied residential property will result in a change to the cost of the Homeowner's Rebate and/or the 1% Cap. We cannot accurately measure these impacts in this exercise.

For property tax year 2002, approximately $4.4 billion was billed for local property taxes statewide. The statewide average property tax rates were $8.56 for primary and $3.93 for secondary.

	Full Cash Value-Taxable	**Net Assessed Value**	**Estimated Tax bill, using statewide average rates-before HOR and 1% cap**
Residential (owner occupied and rental)	182,682,398,620	18,268,239,862	$2,246,741,666
Business personal	21,702,985,188	5,425,746,297	$677,381,871

Currently, the assessment ratios range from 1% for historic property to 25% for commercial property, mines and utilities. Homeowner and rental residential property is assessed at 10%. When comparing only Business personal property and residential property, in tax year 2002, the average assessment ratio statewide was roughly 11.6%.

If we were to apply this average to all residential and business personal property, the overall property valuation statewide would not change. However, the mix of taxable property value in each taxing jurisdiction would change. Since many of the taxing jurisdictions would still raise the same amount of money through property taxes, the result would be a shift in tax responsibility among the property owners.

11.6% Assessment Ratio for Residential and Business Personal Property

	Full Cash Value-Taxable	**Net Assessed Value**	**Estimated Tax bill, using adjusted statewide avg. rates-before HOR and 1% cap**	Difference
Residential (owner occupied and rental)	182,682,398,620	21,191,158,240	$2,608,292,068	$361,550,402
Business personal	21,702,985,188	2,517,546,282	$314,556,783	($362,825,088)

Clearly, as the homeowner tax bills increase, the state would have to fund more in the Homeowner's Rebate and 1% cap, so while this proposal would save business property owners money, it would be funded by residential property owners and the state.

The second part of the proposal is to lower the Business Real property assessment ratio. With no specifics in the proposal, a 20% assessment ratio for Business real property was chosen. Without a counteracting change somewhere else, the impact of lowering the assessment ratio for just one class means that the tax rates will increase, and all the other property owners would fund the reduction for the business real property.

	Full Cash Value-Taxable	**Net Assessed Value**	**Estimated Tax bill, using statewide average rates-before HOR and 1% cap**
Residential (owner occupied and rental)	182,682,398,620	18,268,239,862	$2,246,741,666
Business real	38,903,069,456	9,725,767,364	$1,146,861,833
Business personal	21,702,985,188	5,425,746,297	$677,381,871

20% Assessment Ratio for Business Real Property using $9.02 primary and $4.15 secondary rates

	Full Cash Value-Taxable	**Net Assessed Value**	**Estimated Tax bill, using adjusted statewide avg. rates-before HOR and 1% cap**	Difference
Residential (owner occupied and rental)	182,682,398,620	18,268,239,862	$2,369,086,922	$123,345,256
Business real	38,903,069,456	7,780,613,892	$967,479,157	($179,382,676)
Business personal	21,702,985,188	5,425,746,297	$714,261,156	$36,879,285

Many other options could be tested.